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THE AMERICAN RECOVERY AND REINVESTMENT ACT: Is More Federal Grant Money What the States Need?

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TO END THE current recession, Congress and the Obama administration propose the American Recovery and Reinvestment Act of 2009 (ARRA), an \$825 billion fiscal stimulus package made up of tax cuts and federal spending. A significant component of this package consists of federal grants meant to help states facing unprecedented budget shortfalls.

While federal grants may provide temporary relief for state budgets, the size and scope of the proposed spending will worsen already-distorted state and local fiscal practices while creating perverse incentives inducing greater public spending with scarce state funds. By fracturing the link between those who benefit (local constituencies) and those who pay (federal taxpayers), ARRA reduces government accountability on all levels and ultimately erodes local control over policy by imposing federal solutions on local problems.

Instead of attempting a short-term fix of amplifying the grant system through an emergency stimulus package, the federal government should work to make state and local governments accountable for their own spending decisions. This means reducing states' and localities' reliance on federal funding for local priorities and allowing local activities to be addressed by the appropriate mechanisms: state and local governments and the private and philanthropic sectors.

BACKGROUND

IN DEVELOPING THE stimulus package, Congress solicited input from governors and mayors. In December, the United States Conference of Mayors released a partial list of 15,221 projects, requested by 641 cities, to be funded through federal programs providing transit, highway, energy, economic development, and public safety grants to states.¹ The mayors' report provoked immediate reaction among commentators, with claims that it is full of pork and wasteful spending.² While the report does

contain requests for traditional infrastructure projects such as sewers, rail lines, and roads, there are also requests for dog parks, aquariums, bike paths, civic centers, and tennis courts.

The debate over how to allocate stimulus funds points to three perennial issues with federal grants. First, how can grants be designed to achieve their purpose? Second, what are the effects of federal aid on states' fiscal situations? And third, when is funding a local project with federal money "wasteful" as opposed to "legitimate" spending?

One intent of the ARRA is to help states overcome unexpected budget shortfalls. However, some of the budgetary problems facing the states may be due, in part, to the fiscal distortions of federal grants on state and local budgets.

FEDERAL AID TO STATES AND LOCALITIES: THE OPTIMAL DESIGN PROBLEM

FEDERAL AID TO the states falls under three categories: (a) general revenue sharing (pure cash transfers with no restrictions on usage), (b) block grants, which permit grantees to spend funds in accordance with broad federal guidelines, and (c) tightly controlled categorical grants that direct funds to specific uses.³ These categories contain additional features to ensure that funds are put to the right uses and that local and state governments do not rely solely on federal funds to achieve national policy objectives.

Optimal grant design has been debated for decades.⁴ Block grants tend to be popular with state and local governments since they allow more flexibility in how funds are ultimately spent. However, this flexibility also makes it harder to ensure that funds are put to the purpose envisioned by Congress. This may lead Congress to impose more regulations on block-grant usage, resulting in their "re-categorization."⁵ These dueling views over grant design underscore the ongoing uncertainty from both Congress and grant recipients about the best way to target federal funds to address local problems such as economic development, social service provision, and public safety.

THE FISCAL EFFECTS OF GRANTS

ONE INTENT OF the ARRA is to help states overcome unexpected budget shortfalls. However, some of the budgetary problems facing the states may be due, in part, to the fiscal distortions of federal grants on state and local budgets.

Grants induce spending.

One effect of federal grants on lower levels of government is that they may induce local public spending. Thus, because citizens can pass on part of the cost of local projects to federal taxpayers, they may demand more spending than they otherwise would.⁶ Citizens perceive the costs of public spending differently the more spending and taxing decisions are kept separate, creating a kind of "grant illusion."⁷ Because of this illusion, federal aid comes with the impulse to spend more.⁸

The matching requirement of many categorical grants also induces local spending. Matching stipulates that states commit some of their own resources as a condition of receiving federal aid. This is intended to ensure that federal funds supplement, rather than replace, local funding for designated activities.⁹ However, one unintended result is that states dedicate more resources than they would otherwise to areas where there isn't much need in order to qualify for federal funding, leaving other areas underfunded.¹⁰

Grants erode state and local autonomy.

Federal grants, by defining what goods and services need to be provided on the local level, affect how localities choose what mix of goods and services to provide to their citizens and how to provide them.¹¹ Thus, federal grants may not meet the actual needs of states and localities. Federal grants mold state and local budgets and homogenize the provision of services.¹² Federal funds may also subsidize unsustainable fiscal choices in recipient governments. By introducing a gap between the source of revenues (federal) and where funds are spent (localities and states), federal grants soften state and local budget constraints, dulling the fiscal consequences of local governments' spending decisions and creating local constituencies.¹³ Ultimately, by reducing local governments' autonomy, federal grants weaken their authority to make policy.

Grants weaken federalism.

Federal transfers weaken the institutions of federalism that enable a growing economy.¹⁴ Economic growth requires institutions that enable discovery and exploitation of gains from trade and thereby, wealth creation. A government strong enough to define and enforce property rights and contracts is also strong enough to confiscate wealth. Federalism provides a solution. By decentralizing power, federalism encourages local governments to design policies that compete for people and capital. To preserve markets, federalism must not

tamper with the hard budget constraint facing subnational governments. When the federal level bails out the lower level, it encourages subnational governments to live beyond their means, where they may “engage in more corruption, non-remunerative benefits to interest groups, and endless subsidies to inefficient enterprises.”¹⁵

PORK VERSUS “LEGITIMATE” SPENDING

TO ALLEVIATE CITIZENS’ concerns about waste, the Obama administration vows stimulus funds will be used wisely. The president plans to establish an Economic Recovery Accountability and Transparency Board, to set a “new higher standard of accountability, transparency and oversight,” and to ban all earmarks, “so the American people will know where their precious tax dollars are going.”¹⁶ Draft legislation, however, resembles the mayors’ report in terms of the kinds of programs to be funded through the ARRA.¹⁷

Is this a contradiction? Not technically. Though many of the projects suggested by the mayors are identical to the kinds of projects often requested by members of Congress as earmarks¹⁸ (rules created by a member of Congress that direct agency funding to a specific use¹⁹), the mayors’ projects are not, strictly speaking, earmarks, because they were developed within the statutory guidelines of programs created by Congress and administered by agencies. Congress awards money to localities for parochial projects as requested by the president and administered by agencies through established programs. Pork is not “a subjective judgment of a project’s merit”—it is the circumvention of established budgetary procedures for projects that benefit narrow constituencies.²⁰

Ultimately, the difference between pork and legitimate spending may be minimal. Consider that unlike entrepreneurs, government’s activity is not guided by monetary profit and loss: There is no guarantee that government funds are put to the best possible use. Pork spending may circumvent established budgetary procedures, but these procedures are no guarantee that the decisions made within the process to allocate taxed resources are the most desirable ones. Governments operate in the dark, whereas entrepreneurs receive constant feedback from consumers helping them reallocate resources according to what is most socially desirable.

In the end, whether a project represents pork or legitimate spending, the consequences are the same: Federal transfers fracture the relationship between those who benefit and those who pay. This produces a “disconnect of accountability.” Programs are defined by federal policies but executed by local government, magnifying political calculation in the allocation of funds.

POLICY OPTIONS FOR CONGRESS AND THE NEW ADMINISTRATION

Increase monitoring of state and local use of federal funds.

Increasing monitoring—through websites and auditing—and reporting of state use of federal funds makes it harder for policy makers at the state and local levels to spend money in ways not intended by the law, but it also reduces flexibility in how funds are spent. Moreover, while monitoring funds is a laudable auditing activity, it may not be sufficient to (a) identify undesirable fund allocations and (b) force governments to correct mistakes. However, considering policy makers’ limited capacity to allocate funds well and in the cases where monitoring is a low-cost activity, monitoring funds may actually make citizens better off. This is because increased monitoring helps reveal corruption and the poor use of public funds, making it harder for policy makers at the state and local levels to spend money in ways not intended by the law.

Increase independence of states and localities by reducing dependence on federal transfers.

That federal transfers take place is the fundamental issue at hand. Because the long-term unintended consequences of federal transfers cannot be mitigated through better drafting of proposed legislation, the only way to mitigate the problem in the long run is to reduce and eventually eliminate state dependence on the federal government.

First, this means increasing reliance on state and local funding (including private and philanthropic sources) for local priorities.²¹ Second, regarding public spending that must involve federal transfers (such as Medicare), federal and state governments should establish long-term plans to reduce dependence on federal funds.

CONCLUSION

THE STIMULUS PACKAGE aims to help states by infusing an unprecedented amount of money into the federal grant system. The most profound effect of such a decision, however, will be to deepen the disconnect between revenues and spending. The mayors’ report is a “created demand” for public spending. Local projects result from beneficiaries’ interpretation of federal regulations. The projects are federally decreed and defined by local government and special interests, and thus may not represent citizen needs.

Pundits and others may focus on whether ARRA contains pork, but the real danger is that more federal transfers will amplify the negative effects of the grant system, thereby weakening the autonomy and accountability of local governments and, eventually, the very institution of federalism upon which the entire economy rests.

ENDNOTES

1. The United States Conference of Mayors, *Main Street Economic Recovery: "Ready to Go" Jobs and Infrastructure Projects*, December 19, 2008, <http://www.usmayors.org/mainstreeteconomicrecovery/documents/mser-report-200901.pdf>.
2. See, for example, Robert Poole, "Stimulus Shouldn't Be an Excuse for Pork," *The Wall Street Journal*, December 10, 2008, <http://online.wsj.com/article/SB122887075956093233.html>; and Clifford Winston, "'Stimulus' Doesn't Have to Mean Pork," *The Wall Street Journal*, December 28, 2008, <http://online.wsj.com/article/SB123051204977838501.html>.
3. The federal grant system can be traced to the Hatch Act of 1887 which gave funds to land-grant universities to set up agricultural research facilities. In 1911, the Weeks Act established a grant for forest-fire protection. By 1921, grants were being awarded in highway construction, vocational education, public health, and maternity care. See Ben Canada, *Federal Grants to State and Local Governments: A Brief History* (Washington, DC: Congressional Research Service, February 19, 2003), 5–8, <http://lieberman.senate.gov/documents/crs/grantshistory.pdf>.
4. The grants-in-aid system grew with the New Deal expanding in the 1940s and 1950s. The Johnson administration's Great Society created more grants than during all preceding years in U.S. history. The proliferation of grants resulted in confusion and a lack of coordination on the local level as well as the growth of special interests. This led the Johnson administration to consolidate or "block grant" health programs, and the Nixon administration to "block grant" urban-development programs. The Reagan administration employed block grants as a strategy for gradually reducing federal commitments in many areas of domestic policy. See Timothy Conlan, "The Politics of Federal Block Grants: From Nixon to Reagan," *Political Science Quarterly* 99, no. 2:247–270.
5. Kenneth Finegold, Laura Wherry, and Stephanie Schardin, Block Grants: Historical Overview and Lessons Learned, *New Federalism: Issues and Options for States*, no. A-63 (Washington, DC: The Urban Institute, 2004), 4, http://www.urban.org/UploadedPDF/310991_A-63.pdf.
6. Lars P. Feld and Christoph A. Schaltegger, "Voters as a Hard Budget Constraint: On the Determination of Intergovernmental Grants," *Public Choice* 123:148
7. *Ibid.* See also chapter 10 in James Buchanan, *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice*, in *Collected Works of James Buchanan*, vol. 4 (Indianapolis, IN: Liberty Fund, 2001).
8. This is also known as the "flypaper effect," which posits that a dollar of intergovernmental aid increases public expenditures by more than an equivalent dollar of citizen income. See James R. Hines and Richard H. Thaler, "Anomalies: The Flypaper Effect," *Journal of Economic Perspectives* 9, no. 4 (1995): 217–226.
9. U.S. Government Accountability Office, *Federal Grants: Design Improvements Could Help Federal Resources Go Further*, GAO/AIMD-97-7 (Washington, DC: December 1996), 1, <http://www.gao.gov/archive/1997/ai97007.pdf>.
10. Charles E. Levine and Paul L. Posner, "The Centralizing Effects of Austerity on the Intergovernmental System," *Political Science Quarterly* 96, no. 1 (1981): 68.
11. Because grants change the division of responsibility within the federal system, it has been posited that "grants involve a revision of the Constitution but without formal amendment." See Richard Wagner, *Public Finance: Revenues and Expenditures in a Democratic Society* (Boston: Little, Brown and Company, 1983), 466.
12. Levine and Posner, "Centralizing Effects," 68. State and local budgets "come to resemble the structure and shape of the federal government's domestic program, and local decisions . . . are being shaped by federal constraints and directives at an accelerating rate."
13. See Edward K. Hamilton, "On Non-constitutional Management of a Constitutional Problem," *Daedalus* 107 (1978): 111–28, "We do not know what disciplinary forces can resist impulses to excessive spending when the spender bears no responsibility for raising the revenue being allocated."
14. See Barry Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development," *Journal of Law, Economic, and Organization* 11, no. 1:1–31. As Weingast explains, "This condition [the hard budget constraint] is not met if the central government bails out the lower one whenever the latter faces fiscal problems" (p. 4).
15. Barry R. Weingast, "Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development," (discussion draft, June 2006), 10, <http://politicalscience.stanford.edu/faculty/documents/Weingast-second%20generation%20fiscal%20federalism.pdf>.
16. Associated Press, "Obama bans earmarks from economic package," *January 6, 2008*, <http://www.msnbc.msn.com/id/28525113/>.
17. These include the Community Development Block Grant, Amtrak, Airport Improvement Grants, highway infrastructure, watershed infrastructure, and school construction.
18. For example, Irvine, Texas, suggests \$350 million to build a "Convention Center/Entertainment Venue." Pacific, Washington, suggests \$600,000 for a skate park.
19. Oliver Pollock. See U.S. Government Accountability Office, *Congressional Directives: Selected Agencies' Processes for Responding to Funding Institutions*, GAO-08-209 (Washington, DC: January 2008), <http://www.gao.gov/new.items/d08209.pdf>.
20. Tom Finnigan, *All About Pork: The Abuse of Earmarks and the Needed Reforms, Policy Briefing Series* (Washington, DC: Citizens Against Government Waste, May 3, 2006), <http://www.cagw.org/site/DocServer/PorkFinal.pdf>.
21. This is known as the subsidiarity principle.

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